MicroLoan Foundation
a different approach to charity

Microfinance

A briefing paper from the MicroLoan Foundation

Introduction

Microfinance is essentially the provision of financial services to the "unbanked" – those who are unable to gain access to conventional forms of finance. The most common form of microfinance is microcredit – small loans to groups or individuals – though other services such as microsavings and microinsurance also play an important role.

The concept of microfinance has gained exposure in recent times after Dr. Muhammad Yunus at Grameen Bank won the Nobel Peace Prize in 2006. Yunus, one of the pioneers of the microfinance sector, is best known for his role in developing a system of group lending. This involves individuals forming themselves into a group within their community, and taking collective responsibility for repaying each other's loans. This process of "joint and several liability" is still widely used within the microfinance community as a way of guaranteeing loans without having to request collateral.

The term microfinance is today used to describe a vast range of business models, funding mechanisms and organisation structures. At one end of the scale, there are commercial banks dedicated to microfinance, providing loans of perhaps $1,000 to small-scale entrepreneurs in urban areas. Compartamos in Mexico – now publicly listed following a successful IPO – is a well-known example of this.

At the other end there are organisations offering microfinance services to the rural poor in Sub-Saharan Africa. These organisations commonly have much smaller loan sizes – as little as $25 – and may also look to provide extra assistance in the form of business and skills training to help meet the needs of their clients.

Clearly therefore, understanding microfinance requires some awareness of what people mean by the term. For example, a microfinance operation working in Mexico, where the Gross National Income per capita is $7,000 and nearly 80% of people live in urban areas, will operate very differently from one focusing on rural Malawi, where the GNI per capita is just $160 and the vast majority of the population are engaged in subsistence agriculture in rural areas.

This paper sets out to explain some of the nuances of microfinance. In particular, it looks at the types of countries served by microfinance, and the differences between commercial and charitable microfinance. It also considers some of the strengths and weaknesses of the different business models that exist under the umbrella of microfinance.

The MicroLoan Foundation

10 Barley Mow Passage
Chiswick
London W4 4PH

contact@microloanfoundation.org.uk

020 8996 1730

www.microloanfoundation.org.uk

Registered Charity Number: 1104287

Contact Details

Peter Ryan
Chairman
peter.ryan@microloanfoundation.org.uk

Joshua Perry
Chief Executive Officer
joshua.perry@microloanfoundation.org.uk

Tom Hall
Partnership Manager
tom.hall@microloanfoundation.org.uk

Sarah-Jane Seel
Programme Officer
sj.seel@microloanfoundation.org.uk

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Where is microfinance found?

Microfinance is sometimes found in comparatively wealthy countries, such as Mexico or South Africa. Indeed, even in the most developed countries of the world, such as the UK, forms of microfinance exist - either through credit unions, or in schemes such as the UK's Prince's Trust, which provides mentoring and small loans to young people looking to set up businesses.

Table 1 below shows the classifications used by the World Bank to define groups of countries by annual income[1]:

Grouping	GNI Range	Examples
Low Income	$905 or less	Bangladesh, Malawi, Solomon Islands
Lower Middle Income	$905—$3,595	Cameroon, Moldova, Philippines
Upper Middle Income	£3,595—$11,115	Botswana, Mexico, South Africa
High Income	$11,115 or more	Czech Republic, Singapore, UK

Table 1—Classification of country income groupings

Clearly, these groupings are only a crude way of looking at the wealth of a country's population. In South Africa, for example, there are areas where people live in poverty comparable to the poorest regions of the world. Therefore, when considering the types of microfinance likely to be present in a given country it is valuable to spend some time considering the situation of the country. Useful indicators include income levels, literacy and education levels, life expectancy, and population demographics.

Commercial microfinance

Commercial microfinance institutions (MFIs) structure a profitable business model around the functions of conventional financial services, scaled down to "micro" levels. This does not prevent them from being socially responsible, or "pro-poor" – Compartamos, a Mexican MFI and bank that is part of the ACCION network, describes itself as a "social company", for example. Similarly, Kenya's K-REP describes itself as a "commercial bank" with a "social mission".

This form of microfinance is most commonly found in middle income countries, or the urban areas of poorer countries. Kenya, for example, has a GNI/capita of only $540[2] but K-REP focuses on urban areas and entrepreneurs with existing businesses. In contrast, there are smaller organisations such as EB-F and RAFOD which provide charitable microfinance in rural and peri-urban parts of the country. All are microfinance institutions, but the actual services offered by each organisation vary considerably due to the dissimilar nature of their client base.

Another area in which private investment is playing an increasing role in microfinance is through the wholesale funding of MFI loan books. In recent years, investors have begun to create investment funds for the microfinance sector offering a market rate of return. The first widely cited example of this was Profund, a $23m Latin American fund created by a group of investors headed by ACCION in 1995. Large, multi-national banks are also now becoming increasingly involved in this area – Citigroup, HSBC and Morgan Stanley all have microfinance divisions providing services such as loan guarantee funds, operational support and commercial wholesale lending to MFIs. In the UK, Morgan Stanley has a well established microfinance department, providing wholesale funding to microfinance institutions. They have even repackaged microfinance debt into structured investments such as Collateralised Debt Obligations (CDOs), which are then sold on to institutional investors.

Below is a summary of the strength and weaknesses of commercial microfinance:

Strengths	Weaknesses
Works well in urban areas, particularly with clients who are salaried employees or already have small businesses.	Tendency towards "safer bets" who are able to service larger loans means those most in need are often ignored.
Scalable, since no charitable funding is required.	Only scalable in areas where services can be offered cost-effectively (i.e. not rural Sub-Saharan Africa).
Often run by financial professionals who understand the conventional banking sector.	Management focus on maximising investor returns means that additional services such as skills training are rarely offered.
Ability to cross-subsidise poorest borrowers with profits earned from bigger clients results in a sustainable business.	In practice, staff are incentivised to serve profit-making clients so poorer clients are neglected.

Table 2—Strengths and weaknesses of commercial microfinance

[1] Taken from the World Bank Data & Statistics web portal: http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20420458~menuPK:64133156~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html
[2] Taken from the World Bank World Development Indicators database http://devdata.worldbank.org/external/CPProfile.asp?PTYPE=CP&CCODE=KEN

Charitable and not-for-profit microfinance

While much of the financial press focuses on the innovations of commercial microfinance, modern microfinance has its roots in non-profit structures, and many MFIs worldwide believe strongly in the need for such a model.

Grameen Bank of Bangladesh, which was founded by Muhammad Yunus, is a community bank owned by its clients and therefore an example of a working co-operative structure.

Grameen now claims to be sustainable in Bangladesh, meaning that it covers its costs from interest earned on loans, and therefore does not require donor funding. Unlike commercial microfinance, profits are reinvested into the business, or what it calls a “Rehabilitation Fund”, which is set up to provide support and relief in disaster situations.

Some have pointed out that the Grameen Foundation – the non-profit arm of the global Grameen network – provides support to Grameen MFIs by way of loans and grants, technical assistance and R&D, which makes it hard to establish what exactly is meant by being a sustainable operation.

Many not-for-profit microfinance institutions are open about their need for external funding, either to support expansion or to help cover costs. These include global organisations such as FINCA and BRAC, as well as UK based charities such as the MicroLoan Foundation (MLF).

Others, such as Opportunity International (which has a UK support base), have set up full-service “microfinance banks” in a move towards a model that more closely resembles a commercial operation.

Many, though not all, not-for-profit microfinance institutions aim to cover costs, and hence achieve full sustainability (i.e. non-reliance on donor funds). Sustainability is widely considered desirable, since it ensures that initiatives will be meaningful, scalable and long-lasting. In this model, donor funding is used to finance start-up costs or expansion as opposed to propping up a long-term business plan.

However, in many regions, notably sub-Saharan Africa, sustainability can sit at odds with offering universal access to services. For example, a rural client who needs a $25 loan accompanied by business training to set up their first business is far more costly to serve than an urban, educated client taking a $1,000 loan to finance an existing business venture.

Below is a summary of the strength and weaknesses of charitable microfinance:

Strengths	Weaknesses
Sustainable / cost-covering once scale has been reached.	Requires charitable funding initially, in order to cover setup costs.
Management focus on needs of poor clients, with less pressure to structure profitable services.	Risk of “charitable” organisational culture being at odds with principles of sustainability.
Suitable to all environments including rural locales and the poorest areas of the world.	Lack of link to commercial banks makes process of graduation to conventional finance for best clients more difficult.
Allows for risk-taking, either with unproven clients or in areas lacking history of successful business (e.g. agrarian economies, ex-conflict zones).	Risk of suffering higher rates of default, particularly where there is a threat from natural disaster or conflict.

Table 3—Strengths and weaknesses of charitable microfinance

Who is Right?

There is much debate within the microfinance community regarding the ethics of making money from the world’s poorest people. Some, such as eBay’s Pierre Omidyar – a leading advocate of private sector involvement in microfinance – consider that private sector investment is the key to achieving scale and sustainability. He is quoted in the *New Yorker* as describing microfinance as “a self-sustaining, profitable model, which opens the door to reaching large numbers of people who need to be reached by this tool of access to capital.”[3]

However many, including Grameen’s founder Muhammad Yunus, disagree. In the same article he responded by commenting “Why do you want to make money off the poor people? You make money somewhere else. […] When they have enough flesh and blood in their bodies, go and suck them, no problem.”[3]

Ultimately, both charitable and commercial microfinance have important, though differing, roles to play in providing the world’s unbanked with financial services. Few would question the value of commercial microfinance in circumstances where it can provide valuable services at scale. Equally, wherever this is not possible (and in many parts of the world the private sector has simply not yet proved capable of providing universal access to microfinance), charitable MFIs will continue to provide essential support (sustainably or otherwise) to people in living in extreme poverty.

[3] Taken from Millions for Millions by Connie Bruck, New Yorker, 30th October 2006
http://www.newyorker.com/archive/2006/10/30/061030fa_fact1?currentPage=1

About the MicroLoan Foundation

Who we are

The MicroLoan Foundation (MLF) is a UK based microfinance charity which was set up in 2002 by Peter Ryan, now the charity's Chairman. Our mission is to reduce significantly the depth and breadth of poverty in the communities within which we operate.

We do this by providing small loans, basic business training and ongoing mentoring to groups of women in rural & peri-urban areas, concentrating on those most in need. The loans are used by our clients to set up small business ventures, the profits of which feed, clothe, and educate their families, thus enabling them to work their way out of poverty.

To date, MLF has made approximately 15,000 loans to some 7,500 clients, directly assisting around 45,000 family members.

We operate predominantly in sub-Saharan Africa, with Malawi as the lead country and plans for expansion into Zambia and Namibia underway. MLF also supports a microfinance operation in the Philippines and is targeting to set up voluntary fundraising offices in the USA and Australia.

How we differ from other MFIs

Increasingly, microfinance institutions are adopting business models that resemble traditional, top-down, approaches to banking. While such institutions can provide important services, they have not yet proved effective in accessing the poorest communities in rural sub-Saharan Africa.

MLF is different in that we make small initial investments, focussing on the needs of the poorest people in rural and peri-urban areas. Our products and services are then tailored accordingly in order to make them effective. The table below outlines some of the key differences between our focus and that of a traditional MFI.

Traditional MFI	MicroLoan Foundation
Significant urban presence	Focus on rural and peri-urban areas
Clients often salaried employees	Clients predominantly self employed/farmers
Limited training due to high associated costs	8 initial training sessions followed by ongoing mentoring
Average loan size of £100—£500	Average loan size of just £45, starting loan £12
Weekly repayment schedule	Fortnightly/flexible payment schedules
Standard finance products only	Products & training tailored to suit clients

Table 4—Differentiators of MLF

Our Values

We are a charity with an entrepreneurial culture

MLF was established by business people with experience of working in Africa. We are an entrepreneurial and commercially run organisation: our staff and many of our volunteers come from the business community and this therefore has a significant influence on our culture.

We reach those who are most in need

We help the poorest people in the countries in which we operate and therefore focus on working in rural and peri-urban areas.

We develop long term, sustainable improvements in standards of living

Our priorities lie in the development of individuals' businesses and a resultant increase in their household wealth. We develop meaningful long term relationships with our clients. Creating sustainable improvements is more important to us than simply counting the number of loans made.

We create independence from aid

We empower our clients to work their way out of poverty and develop their independence from aid. In order to achieve this, each borrower receives 8 business training sessions prior to receiving their first loan. Each loan is tailored to correspond with each individual's business plan and personal circumstance. Thereafter, ongoing mentoring in the development of their new venture is also essential.

We recognise that quality of life is not just about making money

Providing HIV and nutritional awareness training is integral to our work; illness in the family is a prime cause of bad debts and group drop out. This combination of economic empowerment and health education results in an increase in people's standards of living.

We train in value added skills

We reinforce our lending with training in value added skills such as knitting & sewing, juice making, and vegetable growing with irrigation via our Microventures programme. This allows our proven clients to further expand into higher margin businesses.

We are in it for the long haul

We are committed to making our country operations sustainable in the long term, both from the interest charged on loans and also from ethical trading with our clients and partners.

However, it is integral to our approach that sustainability does not come at the expense of the availability of services to those most in need.